

DIRECT TESTIMONY
OF
JUDITH R. MARSHALL

TELECOMMUNICATIONS DIVISION
ILLINOIS COMMERCE COMMISSION

ILLINOIS BELL TELEPHONE COMPANY
d/b/a AMERITECH ILLINOIS

DOCKET NOS. 98-0252/0335
CONSOLIDATED

NOVEMBER 3, 2000

1 **Q. Please state your name and business address.**

2

3 A. My name is Judith R. Marshall and my business address is 527 East Capitol
4 Avenue, Springfield, Illinois 62701.

5

6 **Q. By whom are you employed and in what capacity?**

7

8 A. I am employed by the Illinois Commerce Commission ("Commission") as an
9 Economic Analyst in the Telecommunications Division.

10

11 **Q. Please describe your education, background and work experience.**

12

13 A. In 1978 I received a Bachelor of Arts Degree in Accounting and in 1981 I received
14 a Master of Arts, Business Administration Degree (later converted to an MBA) from
15 Sangamon State University, now known as the University of Illinois - Springfield. I
16 am a Certified Public Accountant, licensed to practice in Illinois.

17

18 I have approximately five years experience as an Internal Revenue Agent prior to my
19 employment by the Commission in 1982. Prior to assuming my present position, I
20 served as a Staff Accountant, an Audit Manager, and Supervisor of Training in the
21 Accounts and Finance Department and as Supervisor of the Accounting Section in

the Telecommunications Department of the Public Utilities Division of the
Commission.

I am a member of the American Institute of Certified Public Accountants and the
National Association of Regulatory Utility Commissioners ("NARUC") Staff
subcommittee on Education.

Q. What is the purpose of your testimony in this proceeding?

A. My testimony presents an overall summary of Staff's position regarding rates in this
docket. I am primarily responsible for issues associated with merger related costs
and savings and annual monitoring reports. I also sponsor adjustments related to
amortization of a 1994 accounting change.

Q. Do any schedules and attachments accompany your testimony?

A. Yes, I am presenting two schedules. Schedule 4.01 calculates my proposed
adjustments to Ameritech Illinois' operating statement and rate base related to the
disallowance of the amortization of the FAS 71 adjustment. Schedule 4.02 presents
the same five year historical data as Ameritech Illinois Exhibit 7, Schedule 3 with
calculated rates of return on net original cost rate base, with and without the FAS 71
adjustment.

I have also included 3 attachments which are merely copies of data that I received from Ameritech Illinois and which I discuss in my testimony related to the FAS 71 adjustment. Attachment 4.01 is a schedule which calculates the removal of Ameritech's FAS 71 adjustment. Attachment 4.02 is a list provided by Ameritech of items included in the FAS 71 write-off. Attachment 4.03 is an excerpt from Ameritech Illinois' financial report which discusses the FAS 71 write-off.

Overview of Rate Design

Q. At pages 69-70 of his testimony (Ameritech Illinois Ex. 1.1), Ameritech Illinois ("AI") witness Gebhardt discusses the number of rate cases experienced by GTE since 1985 in support of his opinion that Ameritech would not have experienced a rate case absent its Alternative Regulatory Plan. Please clarify the rate changes experienced by GTE during that period.

A. Mr. Gebhardt's testimony on this point fails to address two significant general rate reductions during the 1990's that were voluntarily entered into by GTE following negotiations with Staff. These voluntary rate reductions eliminated the need for Commission initiated investigations of GTE's rates. The first general rate reduction of approximately \$8 million occurred approximately one year after the merger of GTE and Contel. This rate reduction was accomplished in two tariff filings and did

not result in a Commission Order. The second rate reduction in excess of \$10 million was effective upon the merger of GTE and Bell Atlantic (Docket 98-0866). In addition, it should be noted that the rate case filed by GTE during the 1990's resulted in a rate reduction (Docket 93-0301). Therefore, I disagree with Mr. Gebhardt's conclusion that there would not have been another AI rate case following the Commission's 1994 Order absent the Alternative Regulatory Plan ("Alt. Reg. Plan"). In my opinion, AI's reported earnings would likely have led to a Commission initiated rate investigation absent the Alt. Reg. Plan.

Q. Please discuss Mr. Gebhardt's analysis of earnings on non-competitive services (AI Ex. 1.1, pp. 77-80).

A. Mr. Gebhardt correctly notes that a traditional rate case analysis includes a carrier's earnings on all regulated services, both competitive and non-competitive. This is not only a traditional application but is required in a rate case by Commission rule.

While the rates for competitive services are generally determined by market forces, these services remain by definition regulated services unless specifically deregulated by either the Commission or the FCC. [83 Illinois Administrative Code Part ("Part") 711]. The Commission has the authority to investigate competitive rates and the responsibility to assure that rates for competitive services are just and reasonable. Therefore, I disagree with Mr. Gebhardt's assessment that any

earnings analysis must be limited to earnings on non-competitive services. I believe that it is entirely appropriate for the Commission to consider AI's earnings from regulated services as a whole.

Q. Has the Commission previously requested information on earnings related to competitive services and earnings related to non-competitive services?

A. Yes. This question was posed during the Commission's pre-bench session on December 14, 1999. At that time, Staff contacted Ameritech informally and AI representative Robert Reter was unable to provide such information because there was no generally accepted methodology to allocate embedded costs between competitive and non-competitive service categories. Ameritech now takes an inconsistent position by allocating earned returns between competitive and non-competitive services on an arbitrary basis.

I agree with Mr. Reter's original assessment. Rate of return data are not reported to the Commission on a competitive/non-competitive basis. The accounting records required by the Uniform System of Accounts ("USOA") do not allocate costs between competitive and non-competitive services; thus the requested data are not readily available.

109 **Q. Is there any basis for Mr. Gebhardt's allocation of earnings between**
110 **competitive and non-competitive services?**
111

112 A. No. There is no relationship between the revenues utilized by Mr. Gebhardt in
113 preparing Ex. 1.1, Schedule 7 and the embedded costs of providing service.
114 Likewise, there is no relationship between the long run service incremental cost
115 ("LRSIC") and the embedded cost of providing service. Calculations of earned
116 rates of return are based upon embedded costs. In my opinion there is no reliable
117 method for calculating AI's earned returns on non-competitive services over the life
118 of the Alt. Reg. Plan.
119

120 **Q. In the event that the Commission implements a rate reduction, how should**
121 **Ameritech Illinois' revenue requirement be allocated between competitive**
122 **and non-competitive services?**
123

124 A. In that event, the Commission should apply the traditional rate setting procedures
125 discussed above. Once the revenue requirement has been determined, the
126 revenue from competitive services is subtracted from the revenue requirement. The
127 balance is the revenue required to be produced from non-competitive services.
128 This approach must be used so long as it produces a reasonable result. A
129 reasonable result generally requires that non-competitive services be priced at or
130 above LRSIC.

Once the Commission determines reasonable rates for non-competitive services, it serves no purpose for the Commission to require any further rate reductions. Rates for competitive services could be returned to existing levels or increased at any time, upon 1 day's notice. (Part 745) Therefore, I recommend that the Commission limit any rate reduction to non-competitive services in an amount that produces a reasonable result. This may require a rate reduction in a lesser amount than that shown in Staff's revenue requirement calculation.

Q. Is there another alternative that the Commission could implement?

A. Yes, the Commission could choose to allocate AI's revenue requirement between competitive and non-competitive services based upon either comparative revenue or comparative LRSIC, or by selecting a point between the percentages produced by these methods. Data is available for both of these comparisons and Staff witness Hanson provides the results of these allocations in his testimony (Staff Ex. 14.0). In the event that the Commission elects to allocate a portion of AI's revenue requirement to competitive services, the Commission could impose a cap on any competitive rates reduced in this proceeding. Failure to cap competitive rates would likely result in AI continuing to earn more than Staff's recommended rate of return.

Q. Who is responsible for Staff's detailed rate design?

A. Staff witness Mark Hanson discusses Staff's specific rate design proposals in Staff Exhibit 14.0.

Merger Related Costs and Savings

Q. Please explain the Commission requirements with respect to merger costs and savings.

A. In its September 23, 1999 Order in Docket 98-0555 approving the merger of Ameritech Corporation and SBC, the Commission required that one-half of net actual merger savings be flowed to AI's customers. Actual net merger savings are tracked on a calendar year basis and reported in AI's annual price cap filing. The Commission also required that an independent third-party auditor be retained to review the methodology and standards for tracking merger savings, as well as to audit the amount of net merger savings on an annual basis. (Order, Docket 98-0555, p.149). This condition of the merger is scheduled to terminate with the Commission's final order in the instant proceeding. (Id., p.146).

Q. What is the status of the Commission ordered third party review of merger costs and savings?

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176 A. The Barrington Wellesley Group, Inc. ("BWG") was retained by the Commission to
177 perform these functions. Their analysis of SBC methodology for tracking merger
178 related costs and savings has been delayed beyond the expected September 2000
179 date due to the preliminary nature of the data available from SBC. BWG's final
180 report on this project is currently expected by January 8, 2001. The timing of this
181 report will not allow the parties to address it within the current schedule for filing of
182 testimony in this docket. It is also important to note that the only actual audited data
183 included in BWG's report will be for post merger year 1999, a period of less than
184 three months. Final year 2000 data will be available for audit during 2001. I
185 anticipate that another docket will be required to allow the parties to present
186 evidence addressing BWG's final report. (See, Docket 00-0260, pp. 9-11).

187

188 **Q. What has Ameritech Illinois proposed regarding the treatment of merger**
189 **costs and savings in this case?**

190

191 A. AI witness Theresa P. Larkin proposes that the terms of the Commission's merger
192 order continue to be applied during the period from October 1999 through
193 December 31, 2002. She proposes that the net merger savings for the year 2002
194 be considered the permanent, going-forward level for merger related savings
195 resulting in a permanent one-time adjustment to the PCI. (AI Ex. 3.0 pp. 29-34).

196

Q. What is your recommendation regarding merger costs and savings?

A. In my opinion, the period recommended by Ms. Larkin is not sufficient to capture all merger related costs and savings at a going-forward level. Much of the delay associated with the current audit is due to the unavailability of actual audited data on an expedited basis and to the time required by SBC to implement a system for tracking merger costs and savings. Therefore, I recommend that the terms of the merger condition remain in effect until the Commission completes its next review of the alternative regulation plan. It is Staff's position that the plan adopted by the Commission in this docket will be reviewed in approximately four years, with a final order in place prior to July 1st of the fifth year. (Staff Ex. 1.0) It is not necessary for the Commission to pre-judge what should occur at the end of the five year period.

Annual Reports Under Alternative Regulation

Q. Should AI be required to file annual reports under any alternative regulation plan that the Commission adopts?

A. Absolutely, annual or more frequent reports are required by Section 13-506.1 (d) of the Public Utilities Act ("PUA") which states:

Any alternative form of regulation granted for a multi-year period under this Section shall provide for annual or more frequent reporting to the Commission to document that the requirements of the plan are being properly implemented.

221

222 The purpose of these annual reports is to document that the requirements of the
223 plan are being properly implemented. Therefore, every requirement or condition of
224 the alternative regulation plan should be addressed in these reports. These reports
225 provide valuable information to Commissioners, Commission Staff and the public
226 regarding AI's operations under the alternative regulation plan. It is appropriate that
227 all information related to the alternative regulation plan be available in a single
228 report.

229

230 **Q. What information is AI currently required to include in its annual report**
231 **under the alternative regulation plan?**

232

233 A. The following information is included in AI's annual reports under its alternative
234 regulation plan:

- 235 1. Total Company and Illinois jurisdictional rate base for the preceding
236 calendar year adjusted to reflect regulatory treatment ordered in Dockets
237 92-0448/93-0239;
- 238 2. Total Company and Illinois jurisdictional operating revenue and expenses
239 for the preceding calendar year adjusted to reflect the regulatory
240 treatment ordered in Dockets 92-0448/93-0239;
- 241 3. Other income and deductions, interest charges, and extraordinary items
242 for the preceding year (with explanations);

4. Preceding calendar end-of-year capital structure;
5. Calculated total Company and Illinois jurisdictional return on net utility rate base and total Company return on common equity;
6. Statement of Sources and Applications of Funds for the preceding calendar year;
7. Description of proposed projects and amounts to be invested in new technology (regarding the Company's \$3 billion infrastructure investment) for the current calendar year and a comparison with the actual projects and amounts invested in new technologies during the preceding calendar year;
8. Calculation of the current price cap index and actual price indexes including the formulas used, the inflation factor and its source, the general adjustment factor, the exogenous factor and a description of its calculation, and the service quality component and a description of its calculation;
9. A description of new services offered in the preceding calendar year, including the price of each and its effect on the calculation of API;
10. Demand growth by revenue basket in the preceding calendar year;
11. Summary of price changes initiated under the Alternative Regulatory Plan in the preceding calendar year;
12. A demonstration that Section 13-507 of the Act has been complied with during the preceding calendar year;

13. A summary report on AI's quality of service during the preceding
calendar year; and

14. A summary report on the exogenous events that affected the exogenous
factor of the price cap index formula. (Order Docket 92-0448/93-0239,
Appendix A, pp. 7-10).

Q. What does AI propose regarding these annual reports?

A. AI witness David Gebhardt addresses monitoring and reporting requirements at
pages 5-13 of AI Exhibit 1.0. In summary, Mr. Gebhardt objects to the form of the
Infrastructure report and states that it need not be retained if the infrastructure
investment commitment is not retained. He objects to requirements 1-6 because
they provide financial information that permits users to determine the Company's
earnings levels and believes that requirements 8-11 and 13-14 are unnecessary
because this information is provided in AI's annual price cap filing. Mr. Gebhardt
does not object to requirement 12 so long as Section 13-507 remains in the PUA.

**Q. Should the infrastructure investment requirement be continued under any
alternative regulation plan adopted or modified in this docket?**

A. Yes, it should. The Commission imposed the additional \$3 billion infrastructure
investment as a condition of its approval of the merger of Ameritech and SBC.

SBC agreed to this condition when it accepted the terms of the Commission's Order. While the Commission's Order allowed for re-consideration of the amount of the infrastructure investment requirement during the instant proceeding, there is nothing in the Commission's Order to suggest that this requirement should not continue in place either for five years or until it has been satisfied. (Order Docket 98-0555, p. 238) There is no evidence in the record of this docket indicating that the amount of this agreed condition should be modified, and I have no basis to propose a specific modification at this time. I will respond to any testimony addressing revision of the amount of the investment commitment in my rebuttal testimony.

Q. Did the Commission impose specific requirements regarding the agreed \$3 billion infrastructure investment commitment?

A. Yes, it did. Condition (7) Network Infrastructure Investment requires a report in sufficient detail to allow the Commission to determine whether and how the investment was made, whether it serves to maintain the quality of AI's network, and whether the investment is in the interests of all of AI's customer classes. These reports will be audited by an independent third party selected by the Commission and must be expressly approved by the Commission.

308 **Q. How was the information currently required to be in AI's Infrastructure**
309 **Maintenance Reports determined?**

310

311 A. On March 30, 1995, when the initial Infrastructure Maintenance Report was filed in
312 accordance with AI's Alternative Regulation Plan it did not contain sufficiently
313 detailed information to satisfy the then Chairman of the Commission (Mr. Miller) or
314 the Executive Director (Mr. Fisher). The Commission's Order required the report to
315 present a comparison of budgeted and actual amounts. At that time, I
316 recommended that budgeted and actual amounts be provided for each project
317 contained in the report. The solution suggested by AI was to report its information
318 by budget "satisfiers" for this comparison. This solution was ultimately accepted by
319 the Commission Staff as a compromise, although this was not reflected in a specific
320 Commission Order. On September 21, 1995, AI filed its revised infrastructure
321 report which included actual 1994 and budgeted 1995 data grouped into budget
322 satisfiers. Subsequent reports have been filed on that same basis.

323

324 **Q. Should the annual infrastructure maintenance report contain additional**
325 **information?**

326

327 A. It remains my opinion that both budgeted and actual expenditures should be
328 reported by project. Clearly, the Commission indicated its desire for a detailed
329 report in the merger Order cited above. The audit requirement also supports the

need for more detailed information than is currently required. The third party will determine what information is needed for its audit, but it is likely that this information will be requested on a project basis.

As an alternative, the Commission may wish to consider requiring that only summary data be included in each annual report, while continuing the requirement for a detailed, audited, and Commission approved infrastructure report for purposes of complying with the merger Order. However, it is my opinion that the public is best served by having all information related to an alternative regulatory plan available from a single source. Therefore, if the infrastructure maintenance investment commitment is considered a condition of an alternative regulatory plan, it is appropriate to include a detailed report in each annual report required under the PUA.

Q. Should the financial information contained in items 1 through 6 of the reporting requirements be retained?

A. It is my opinion that these reporting requirements should be retained because they provide useful information to aid the Commission and the public in monitoring AI's performance under the alternative regulatory plan. It has been my experience that these reports are reviewed by individual Commissioners, Commission Staff and various other parties.

352

353 Section 13-506.1 of the PUA provides that:

354 (e) Upon petition by the telecommunications carrier or any other person
355 or upon its own motion, the Commission may rescind its approval of
356 an alternative form of regulation if, after notice and hearing, it finds
357 that the conditions set forth in subsection (b) of this Section can no
358 longer be satisfied. Any person may file a complaint alleging that the
359 rates charged by a telecommunications carrier under an alternative
360 form of regulation are unfair, unjust, unreasonable, unduly
361 discriminatory, or are otherwise not consistent with the requirements
362 of this Article; provided, that the complainant shall bear the burden of
363 proving the allegations in the complaint.
364

365 Because the requirement to satisfy the statutory conditions is continual, it is
366 important that basic financial information be provided on an ongoing basis. Other
367 financial reports filed by AI do not provide Illinois jurisdictional rate base, operating
368 revenue, or expenses adjusted to reflect regulatory treatment ordered by the
369 Commission. The annual report required by the alternative regulatory plan is
370 currently the only source of this information.

371

372 **Q. What is your position regarding reporting requirements 8 through 11 and 13**
373 **through 14 which contain some of the same information that is available in**
374 **Ameritech's annual price cap filing?**

375

376 A. While I agree that the information in these reporting requirements is included in
377 Ameritech's annual price cap filing, the purpose of their inclusion in the annual
378 report is to provide a single source for all information related to AI's alternative

regulatory plan. For this reason, I recommend that these reporting requirements be retained.

Amortization of FAS 71 Adjustment

Q. Please describe the adjustment you propose to both the Company's historical data and the 1999 test year data to disallow the amortization of AI's FAS 71 adjustment.

A. The adjustments that I propose on Schedule 4.01 reflect the removal of the FAS adjustment from the test year data. AI has also provided data which assumes that the FAS 71 write-off never occurred and increases rate base by adjusting accumulated depreciation reserve and accumulated deferred tax reserve. These rate base adjustments are included on Schedule 4.01 and reflected in Staff's calculation of Ameritech Illinois' revenue requirement.

Q. Is there an alternative adjustment that the Commission should consider?

A. Yes. It is equally appropriate for the Commission to determine that the FAS 71 adjustment did occur, and, further, that it was a one-time, non-recurring event which took place outside of a rate case test year. Under this assumption, the Commission should disallow the amortization expense, but would not adjust the rate base as if

the write-off had never occurred. This adjustment is not included in Staff's revenue requirement calculation but is reflected on line 17 of Schedule 4.02. This treatment of the write-off is consistent with AI's financial reports.

Q. Please discuss Ameritech Illinois' proposed FAS 71 Adjustment.

A. Ameritech has included in its reported data an eight year amortization of FAS 71 charges which is not appropriate for rate making purposes. A detailed list of the items included in the write-off was provided to Staff as part of Docket 96-0178, commonly known as the CUB complaint case, and is attached to this Exhibit as Schedule 4.02. The most significant item included in this write-off is the depreciation reserve deficiency. The Commission addressed the depreciation reserve deficiency in its Order in Docket 92-0448. The Commission found that, with the exception of the analog switching reserve deficiency, the remaining life depreciation methodology which allows for recovery of any reserve imbalance over the life of the account was appropriate and rejected any amortization of a reserve deficiency. (Order Docket 92-0448, p. 148) For the analog switching reserve deficiency, the Commission found a 5 year amortization reasonable. (Id., p. 150). That 5 year amortization period has expired. Therefore, no adjustment related to a depreciation reserve deficiency should be allowed in setting rates for the future.

The balance of the write off, approximately \$80 million (before taxes), is made up of several items for which the Commission has also previously prescribed regulatory treatment or denied recovery from ratepayers. Ameritech's proposed eight year amortization of these costs ignores the Commission's prior orders dealing with these costs. The written down assets titled "compensated absences", "unpaid medical expenses", "deferred incentive pay", and "Lifeline Link up" refer to specific Commission ordered adjustments which disallowed these expenses in past rate cases. The deferred charges related to the Shortino case were allowed to be recovered through a surcharge on pay telephone calls. Ameritech Illinois reported to the Commission that all Shortino costs had been recovered through these surcharges by 1989 and the surcharges were discontinued. Charges related to debt issuance, including premiums and discounts, are below the line items which should not be considered as operating expenses of Ameritech Illinois for regulatory purposes.

In addition, it is well established regulatory policy that rates are set for the future and should reflect future conditions that match the period for which rates are expected to be in effect. The FAS 71 write off was a one-time, non-recurring event that took place prior to the 1999 test period being utilized in this case. It reflects costs that were incurred as long ago as 1983 and amortization of costs all of which have either been specifically disallowed by previous Commission Order or have expired prior to 1999. For all of these reasons, Ameritech's proposed 8 year amortization of these costs is not appropriate.

445

446 **Q. Does this conclude your testimony?**

447

448 A. Yes, it does.

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